

## Fitch: Activist Investor Activity Distracts U.S. Restaurants

Written by Australian Business

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NEW YORK--( [BUSINESS WIRE](#) )--Increased activist investor activity in the restaurant space portends change for the U.S. restaurant industry and is a testament to the fact that shareholder demands continue to rise despite challenging operating conditions, according to Fitch Ratings. Darden Restaurants Inc. (Darden), Bob Evans Farms, Inc., and Cracker Barrel remain under pressure as a function of this type of activity.

Fitch does not immediately factor threats from activist investors into ratings since many overtures are unsuccessful but continually monitors developments to adjust ratings should changes in operating or financial strategy become likely. However, we take activist investor activity very seriously, as it is a huge distraction to management with proposals having the potential to significantly increase leverage in order to reward shareholders. The presence of activist investors therefore raises event risk for creditors.

Fitch placed Darden's ratings on Rating Watch Negative in December 2013 following the company's announced strategic actions, the most significant of which is the potential separation of Red Lobster and downward revision of fiscal 2013 earnings. Darden's was downgraded to 'BBB-' from 'BBB' in October 2013 due to persistently weak same-restaurant sales, declining operating income, and because leverage and free cash flow (FCF) would not improve as fast as originally anticipated. The separation of Red Lobster should result in more stable operating cash flow and higher margins but Olive Garden continues to experience serious pressure and will represent the preponderance of the firm's sales and operating cash flow over the intermediate term. Moreover, due to potential for a still high dividend payout, uncertainty remains as to the timing of any meaningful improvement in FCF.

Although no final decision has been made on the form of separation which is targeted for completion early in the fiscal 2015 year that begins May 26, 2014, Darden expects to execute a tax-free spin-off of Red Lobster to shareholders but may also consider a direct sale. The spin-off is subject to final approval by Darden's board of directors, confirmation of the tax-free nature, and other customary conditions. We believe the Red Lobster separation is motivated by a combination of Darden's longer term views regarding requirements for Red Lobster to be successful and agitation by activist investors. We also believe the separation is likely to be completed but are concerned that an additional activist investor has taken a meaningful stake in order to push for further changes to enhance shareholder value.

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In addition to Barrington Capital Group, LP (Barrington), which owns 2.8% of Darden's common stock and went public with its proposals in September 2013, Starboard Value LP (Starboard) disclosed a 5.6% stake in the restaurant chain on Dec. 23, 2013, a week after Darden announced its strategic initiatives. Barrington proposes that Darden unlock value for shareholders by creating two independent publicly traded operating companies and monetizing its real estate via a private sales-leaseback transaction or a public REIT. One operating company would consist of Darden's faster growing LongHorn Steakhouse and Specialty Restaurant Group while the other would manage the firm's mature Olive Garden and Red Lobster brands. Both Barrington and Starboard view Darden's plan to separate Red Lobster as incomplete and inadequate, mainly because the company is not looking to monetize its real estate holdings, and are seeking further discussions with management. At the fiscal year ended May 26, 2013, Darden owned the land for 49% of its 2,138 restaurants and has indicated that real estate related to Red Lobster will be included in its separation.

For more information on this topic, please see our special report, titled "2014 Outlook: U.S. Restaurants, Shareholder Demands to Rise, Even as Market Share Battle and Cost Pressures Continue," published on Dec. 2 and available at website [www.fitchratings.com](http://www.fitchratings.com).

Additional information is available on [www.fitchratings.com](http://www.fitchratings.com).

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